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Transition

It is my strong conviction that inflation remains the Nation's number one economic problem. To fight inflation . . . we must concentrate on reducing the budget by holding down Federal spending and foregoing tax reductions, (and) monetary policy will have to continue firmly in support of the same anti-inflationary goals.

So commented President Carter in his State of the Union message in January 1980, when he announced that he would cut the budget deficit for fiscal year 1981 in half to $16 billion. The issue of inflation pervaded economic and political arguments of the time. In the financial services industry, inflation had been the mother of financial innovations, but these innovations, unshackled by government regulation, in turn, presented grave threats to the traditional regulated financial industry.

This *Letter* reviews major developments in the nation's economy during the transition from the Carter Administration to the Reagan Administration and the passage of what Senator Proxmire hailed as the most significant piece of financial legislation since the Federal Reserve Act of 1913 — the Monetary Control Act of 1980.

Inflation

In his State of the Union and budget messages to the Congress early in 1980, President Carter called for increased efforts to reduce supply-related cost pressures, including an expansion of job training programs for disadvantaged youth and programs to increase domestic energy supplies to reduce the nation's heavy dependence on foreign sources. He also called for increased efforts to simplify and reduce costly government regulation.

His FY 1981 budget was projected to rise by 9 percent in current dollars. With the rate of inflation projected at 8 percent (as measured by the GNP deflator), the increase in the budget in real (inflation-adjusted) terms, was only 1 percent, even with an accelerated (3 percent) increase in real defense spending. He emphasized that "to reduce inflation in subsequent years, the budget will have to remain tight," and he also forecast a "mild recession" early in 1980.

Rites of Spring I

The Spring of 1980 witnessed a number of dramatic developments. On the heels of a 13 percent increase in 1979, the consumer price index hit a 17 percent annual rate of increase in March. Following President Carter's order invoking the 1969 Credit Control Act and the somewhat reluctant implementation by the Federal Reserve of a stiff program of credit controls aimed at reducing inflation, the economy took a sharp dip.

The controls were lifted in early Summer and the economy again picked up — along with the rate of inflation. Consequently, and to the great dismay of President Carter, the Fed raised the discount rate by a full point late in September, to 11 percent. When the electorate went to the polls late in November, inflation was still rising at a 12 percent annual rate; interest rates, after a brief drop, were at record levels, bolstered by progressively deepening expectations of continuing inflation (the prime rate hit 17.75 percent); and the unemployment rate reached 7.5 percent.

The rising levels of unemployment and interest rates were attributed by many to the shift in operating procedures and "tighter" stance adopted by the Fed in the interim since October 1979. Over the year (December to December), the nation witnessed a drop in the growth rate of M1 from 7.7 to 6.5 percent. (In contrast, the growth of M2 increased from 8.0 to 8.9 percent and M3, from 9.7 to 10.2 percent.) After the votes were counted in November of 1980, President Carter was convinced that high interest rates had been a major factor contributing to his defeat in his bid for re-election.

Rites of Spring II

The Spring of 1980 also witnessed the passage of the Depository Institutions Deregulation and Monetary Control Act (MCA) late in March. The Act had the strong backing of the Carter Administration and that of the leadership of both the House and Senate Banking Committees. It marked a major step in the direction of promoting greater competition and equity in financial markets, while at the same time strengthening the Fed's direct influence over the fulcrum of monetary control — the reserves of all depository institutions.

The Act also marked the end of a long debate extending from the 1930s, when the Federal Reserve repeatedly, but unsuccessfully, urged that its reserve requirements be extended from just member banks to all *commercial banks.* (Formal membership in the Federal Reserve was, and still is, compulsory for national banks but voluntary for state-chartered banks.) The Fed's recommendation was strongly resisted by state banking authorities and the Congress, but, in 1961, was endorsed by the Commission on Money and Credit (CMC).

In the same time period (mid-1950s and 1960s), the Board of Governors rejected the argument that the rapid growth of "near money" assets, such as the "shares" or savings accounts of *nonbank* depository institutions not subject to System reserve requirements, inevitably would result in "leakages" in monetary control. They would exert this effect partly through their influence on the velocity of the money supply — the rate at which money is spent. This argument was advanced by Stanford Professors Gurley and Shaw and was embraced by, among others, economists of the San Francisco Fed.

The Board of Governors, at the time sensitive to potential charges that it was engaged in a "power grab", rejected the argument in a reply to a question on the subject by the CMC. It asserted that "the long-run rise in the volume of near money assets . . . has not reduced the effectiveness of monetary policy", and, moreover, that velocity had reached its "practical limit" of 3.0 (it was 6.0 in 1986Q4).

Nevertheless, in 1972, the Report of the President's Commission on Financial Structure and Regulation" (the Hunt Commission), and, in 1975-76, the House Banking Committee's study of "Financial Institutions and the Nation's Economy" both recommended that thrift institutions be granted full third-party payment powers, and that *all* institutions offering such accounts be subject to System reserve requirements (and be given access to the Reserve Bank's discount "window"). They also recommended phasing out interest rate ceilings on time and savings deposits which had become an increasingly leaky "umbrella" and had failed to protect depository institutions from "disintermediation" (an outflow of funds) during periods of rising market interest rates.

Harmonizing objectives

In 1975, in response to mounting Board and Reserve Bank concern, System Task Forces were established to address the interrelated issues of Fed membership, competitive equity, and monetary control, including one Task Force on Access to System Services, three of whose six members (including the Chairman) were from the San Francisco Fed. Their report, which envisioned difficult times ahead for the nation's economy in both short and longer term, focused on specific means by which potential conflicts in the System's multiple objectives and responsibilities could be eliminated or minimized. (These objectives included the promotion, through monetary policy, of high and rising levels of income, output and employment, *and* stable prices; the promotion, through the implementation of its supervisory and regulatory functions, of "competition" *and* a "safe and sound" banking and financial system; and the promotion, through its check clearing and other services, of an efficient payments system.)

In pursuit of these objectives, the Task Forces recommended that *all* depository institutions offering payments services be given access to System clearing and other services (including the discount window) irrespective of membership in the System, that the services be explicitly priced to all users, and that reserve requirements be both reduced and applied to all depository institutions.

The withdrawal of hundreds of banks from the System in the mid- and late 1970s in response to the rising "opportunity cost" of membership — the income lost on nonearning reserves held at the System as market rates of interest rose — finally impelled action. According to one Board estimate, the loss of income in the aggregate far more than offset (by at least $650 million) the value of the "free" check clearing and other services provided to member banks by the Reserve Banks.

As passed by the Congress, the MCA embraced the aforementioned recommendations (but exempted institutions with under $2 million in deposits from reserve requirements) together with a six-year phase out of interest rate ceilings on time and savings deposits. It also authorized expanded lending powers for thrift institutions, authority for all depository institutions to offer NOW accounts to individual and nonprofit organizations, and provided for the federal preemption of various state usury ceilings and increased deposit insurance. In addition, it established procedures by which conflicts, duplications, and inconsistencies in financial agency regulations could be eliminated or reduced, and compliance costs thereby minimized.

In most particulars, the MCA thus represented a major step away from the competition and "risk"-restraining attitudes and regulations spawned by the Great Depression, including the deep skepticism regarding the ability of market forces to achieve a desirable allocation of resources.

No other piece of legislation, with the exception of the Federal Reserve Act itself, has exerted such a profound effect upon the System's operational activities. For example, from 147 member banks prior to passage of the MCA in 1980, the San Francisco Fed now processes weekly reserve reports for about 500 member and nonmember banks, in addition to over 35 Edge Act corporations, 124 foreign banks, and about 465 thrift institutions (mutual savings banks, S&Ls, and credit unions). An additional 70 (small) institutions maintain clearing balances and 295 others report quarterly. Over 1,000 of the District's 4,000 depository institutions currently use the Bank's various payments services, and altogether, the volume of the Bank's operations since passage of the MCA has increased by over 40 percent.

Old song, new singers
To some who have been around awhile, the strains of "Happy Days Are Here Again" — a traditional ballad of the Democratic Party — reverberating through the Republication convention in the Summer of 1980 seemed strangely out of place. But the switch was not without precedent.

While campaigning in 1932, FDR had chastised the Hoover Administration for budget deficits that "have added $5 billion to the national debt", and it presumably was with this "early" FDR in mind that candidate Reagan excoriated the deficits of the Carter Administration. Fiscal year 1980 closed $74 billion in the red, almost double the expected shortfall, and FY 1981 was to end with a record $79 billion deficit — far above the $16 billion projected by President Carter early in 1980.

The incoming (1981) Reagan Administration "Program for Economic Recovery" included four key elements designed to enhance incentives, encourage savings and investment, and thereby spur economic growth, while at the same time winding down inflation. They included substantial cuts in business and personal taxes, a reduced rate of growth of federal spending (centering on "entitlement" programs and other nondefense areas in order to accommodate a significant increase in defense outlays in "real" terms), a reduced rate of growth in the money and credit aggregates (some administration spokesman suggested a reduction of perhaps one-half over a six-year period), and a substantial reduction in the burden of regulation.

According to David Stockman, former Congressman and new Director of the Office of Management and the Budget, and Congressman Jack Kemp (R-NY), a "supply side" enthusiast and co-author of the sweeping tax reductions, failure to act forthrightly on these initiatives would result in an "Economic Dunkirk for the GOP".

Moreover, in their view, "recalibration of (the Fed's) monetary objectives and restoration of its tattered credibility is the critical linchpin in the whole program." To this end, they urged President Reagan to "issue (the Federal Reserve Board) a new informal 'charter' — namely, to eschew all consideration of extraneous economic variables like short-term interest rates, housing market conditions, business cycle fluctuations, etc., and to concentrate instead on one exclusive task: bringing the growth of . . . bank reserves (and the money supply) to a prudent rate . . ."

They added that, given this course of action by the Fed, the Administration and the Congress "would stoutly defend the Fed from all political attacks." In view of the rancor that was to follow, it was an imaginative assessment.

Future *Letters* will discuss the evolution of the Reagan Administration's economic program, the course of monetary policy, and other developments affecting the nation's economy in the Brave New World of the 1980s.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/25/87	Change from 3/18/87	Change from 3/26/86 Dollar	Change from 3/26/86 Percent[7]
Loans, Leases and Investments[1] [2]	203,658	– 816	1,312	0.6
Loans and Leases[1] [6]	182,580	– 1,297	– 1,034	– 0.5
Commercial and Industrial	53,812	– 220	659	1.2
Real estate	67,830	– 49	1,530	2.3
Loans to Individuals	37,133	– 95	– 3,675	– 9.0
Leases	5,450	9	– 207	– 3.6
U.S. Treasury and Agency Securities[2]	13,959	473	3,197	29.7
Other Securities[2]	7,119	7	– 853	– 10.6
Total Deposits	205,423	– 1,598	4,674	2.3
Demand Deposits	50,743	– 831	3,804	8.1
Demand Deposits Adjusted[3]	35,942	1,128	3,666	11.3
Other Transaction Balances[4]	19,359	– 80	4,154	27.3
Total Non-Transaction Balances[6]	135,321	– 686	– 3,284	– 2.3
Money Market Deposit Accounts—Total	46,299	– 477	396	0.8
Time Deposits in Amounts of $100,000 or more	32,247	– 248	– 6,213	– 16.1
Other Liabilities for Borrowed Money[5]	22,747	– 1,741	– 5,250	– 18.7

Two Week Averages of Daily Figures	Period ended 3/23/87	Period ended 3/9/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	87	91
Borrowings	11	18
Net free reserves (+)/Net borrowed(–)	77	72

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change